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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Telephone Number:

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Date: FEBRUARY 27, 2012

RE:

Legend:

Taxpayer -
Grantors -
Trust A -

Trust B -
Date -
State -
State Statutes 1-12 -
State Statute 8 -

Dear :

This letter responds to your letter dated August 26, 2011, requesting rulings under §§ 101, 675, 2033, 2036, 2038, and 2042 of the Internal Revenue Code.

On Date, Grantors established Trust A, an irrevocable trust, for the primary benefit of Taxpayer. Taxpayer's brother was named initial trustee of Trust A. During the life of Taxpayer, the trustee has discretion to distribute trust assets to Taxpayer and Taxpayer's descendents for their support, maintenance, health, and education in a reasonable standard of living. Trust A will terminate upon the death of Taxpayer and the remaining trust assets are to be distributed to Taxpayer's descendents. Taxpayer has not represented that Taxpayer or any other individual is treated as the owner of the Trust A under subpart E of part 1 of subchapter J of the Code.

Taxpayer established Trust B, an irrevocable trust, for the benefit of Taxpayer's descendents. Taxpayer has one daughter and one granddaughter. Daughter is the named trustee (Trustee) of Trust B. Taxpayer is prohibited from serving as a trustee.

Article III(A)(1) of Trust B provides that during Taxpayer's life, the trustee (excluding any Insured Trustee) has discretion to distribute to Taxpayer's descendents net income and principal for their health, education, maintenance and support in their accustomed manner of living. Article III(A)(2) provides that the trustee (excluding any Trustee that is related to or subordinate to the Taxpayer and any Interested or Insured Trustee) may also distribute to Taxpayer's descendents so much of the net income and/or principal of the trust as the trustee may from time to time select, for any purpose. Article III(B) provides that upon Taxpayer's death, the remaining trust estate is to be divided into per stirpital shares for Taxpayer's living descendents and held in further trust.

Article VIII provides that the trustee may acquire and retain life insurance on the life of any individual (or the joint lives of any individuals) in which any beneficiary has an insurable interest. The trustee, excluding any trustee related to or subordinate to the Taxpayer and any Insured Trustee (who shall not participate in any decision involving a life insurance policy on such trustee's life or its proceeds), shall have all rights of an owner over life insurance policies assigned to or otherwise owned by Trust B.

Article IX provides the maximum duration of trust is the longest period that property may be held in trust under the applicable rules governing perpetuities, vesting, accumulations, the suspension of alienation and the like (including any applicable period in gross such as twenty-one (21) years or ninety (90) years.)

Article X provides that the trustee shall not reimburse Taxpayer from assets of the trust for the Taxpayer's income tax on the amount (if any) of the gross income of the trust that is reportable directly on the Taxpayer's return under § 671.

Article XIII provides that Trust B is irrevocable. Taxpayer has no right to alter or amend Trust B in any way. None of the income or principal from Trust B may be payable to Taxpayer or be used to discharge any obligation of Taxpayer, Taxpayer's creditors, Taxpayer's estate, or the creditors of Taxpayer's estate.

Article XV provides, in part, that a trustee may appoint successor trustees. No successor trustee or co-trustee appointed by a beneficiary shall be a person or entity that is related or subordinate to such beneficiary within the meaning of § 672(c) and the regulations thereunder.

Article XVI(F)(1) provides that the term "Interested Trustee" means a person who is, or in the future may be, eligible to receive income or principal pursuant to the terms of the trust. If all trustees serving under the terms of the trust are Interested Trustees, a court may appoint a special trustee to serve and exercise the powers of a Disinterested Trustee, i.e., a person who is not an Interested Trustee.

Article XVI(F)(2) provides that the term “Insured Trustee” means a Trustee who is the insured (or one of the insured) under a policy of life insurance held in the trust. No Insured Trustee may participate in the exercise of any incident of ownership over any policy that insures the life of such Trustee.

Article XVI(F)(12) provides that the trustee is prohibited from making, voting on or otherwise participating in any discretionary distribution of income or principal from a trust that would discharge or substitute for a legal obligation of that trustee, including the obligation to support a beneficiary of the trust.

Article XVI(H) provides that the grantor shall have no right, either alone or in conjunction with any other person(s) to revoke, amend or modify this agreement or any trust created by it.

Article XVII provides that the trust shall be governed by the laws of State.

Article XVIII grants a right of withdrawal to each of Taxpayer’s children and grandchildren limited by the gift tax annual exclusion in effect at the time of each contribution and subject to lapse at the end of each calendar year, or if earlier, thirty (30) days after the contribution to which it relates in an amount equal to the greater of the sums referred to in § 2514(e).

Article XIX provides that Taxpayer has the power, exercisable at any time and from time to time in a nonfiduciary capacity (within the meaning of § 675(4)), without the approval or consent of any person in a fiduciary capacity within the meaning of § 675(4), to acquire or reacquire any asset or assets forming part of the trust estate by substituting other property of an equivalent value. Taxpayer shall exercise this power to substitute property by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value, and the Trustee shall have a fiduciary obligation to ensure Taxpayer’s compliance with the terms of this power by being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact of equivalent value, within the meaning of Rev. Rul. 2008-22. This power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

Trust A owns a life insurance policy on the life of Taxpayer. Trust A intends to sell its interest in the policy to Trust B for an amount equal to the value of Trust A’s interest in the policy as determined under § 25.2512-6(a) of the Gift Tax Regulations. The trustee of Trust A will obtain from the issuing insurance company the interpolated terminal insurance reserve value for the policy as of the date of sale and use that amount, plus the proportionate amount of premium last paid before the sale that covers the premium extending beyond the date of sale as the purchase price. Taxpayer will fund Trust B with the amount necessary to purchase the policy. The trustee of Trust B will be designated as the beneficiary of the policy. Trust B may incur debt or policy loans as part of the administration of Trust B.

State Statutes 1-12 invokes the prudent investor rules on trustees.

State Statute 8 provides that if a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

You request the following rulings:

1. Trust B will be treated as a grantor trust with respect to Taxpayer as a result of the application of either/both § 674 or/and § 675.

2. Taxpayer's daughter and granddaughter will not be treated as grantors of Trust B during the life of Taxpayer as a result of any withdrawal right they may have with respect to contributions made to Trust B.

3. The proposed sale to Trust B of the policy is either not a transfer for valuable consideration under § 101(a)(2) or, in the alternative, will satisfy the requirements of § 101(a)(2)(B), and therefore, will not affect the application of § 101(a)(1) to policy proceeds that Trust B will receive under the insurance contract it proposes to purchase from the Trust A.

4. The death of Taxpayer will not be considered as a transfer that could result in a transfer for valuable consideration of the life insurance contract under the provisions of § 101(a)(2), and as a result, under § 101(a)(1) the proceeds from the life insurance contract payable by reason of Taxpayer's death will not be included in the gross income of Trust B even if the life insurance contract is subject to debt or policy loans at the death of Taxpayer.

5. The power to reacquire the corpus of Trust B by substituting other property of an equivalent value will not result in Taxpayer possessing incidents of ownership under § 2042(2) in the policy

6. No portion of the principal of Trust B will be included in Taxpayer's gross estate under §§ 2033, 2036, and 2038 at the death of Taxpayer.

<u>Ruling Requests 1 and 2</u>:

Section 671 provides in part that where it is specified in subpart E of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.

Section 672(a) defines a nonadverse party as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

Section 674(a) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 675(4) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.

Section 675(4)(C) provides that the term "power of administration" means, among other things, a power to reacquire the trust corpus by substituting other property of an equivalent value.

Treas. Reg. § 1.675-1(b)(4)(iii) of the Income Tax Regulations (flush language) provides that if a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) the person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would cause a grantor to be treated as the owner of such portion of the trust within the principles of §§ 671 through 677.

Section 678(b) provides that § 678(a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is otherwise treated as the owner under the provisions of subpart E other than § 678.

The Trust B agreement authorizes Taxpayer to reacquire trust property by substituting other property of an equivalent value. This general power of administration may be sufficient under § 675(4) to treat Taxpayer as the owner of the trust property if the power is exercisable in a nonfiduciary capacity. The circumstances surrounding the administration of the trust determine whether the grantor holds the power of administration in a nonfiduciary capacity. This is question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the Internal Revenue Service office where the returns are filed. Therefore, we cannot determine at this time whether the grantor would be treated as the owner of Trust B under § 675(4). Provided that the circumstances indicate that the grantor holds a power of administration exercisable in a nonfiduciary capacity, the grantor will be treated as the owner of Trust B under § 675(4).

Under § 678(a), the withdrawal rights granted to the beneficiaries result in the treatment of the beneficiaries as owners of the portions of Trust B subject to their respective withdrawal powers, unless as provided in § 678(b), the grantor is treated as the owner. If it is determined that Trust B is a grantor trust under § 675(4) with respect to Taxpayer, then it is a grantor trust in its entirety with respect to Taxpayer notwithstanding the withdrawal rights held by the beneficiaries that would otherwise make them owners under § 678(a).

Ruling Requests 3 and 4:

Section 101(a)(1) provides that, except as otherwise provided in § 101(a)(2), 101(d) and 101(f), gross income does not include amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured.

Section 101(a)(2) provides, generally, if a life insurance contract, or any interest therein is transferred for valuable consideration, the exclusion from gross income provided by § 101(a)(1) is limited to an amount equal to the sum of the actual value of the consideration and the premiums and other amounts subsequently paid by the transferee.

The term “transfer for valuable consideration” is defined for purposes of § 101(a)(1) in § 1.101-1(b)(4) as any absolute transfer for value of a right to receive all or part of the proceeds of a life insurance policy.

An exception to the general rule of § 101(a)(2) is provided in § 101(a)(2)(B) when the contract is transferred to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. In these cases, the general rule of § 101(a)(2) will not affect the application of § 101(a)(1) to the amount received by the beneficiaries.

A “grantor trust” is generally disregarded for federal tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184, provides that if a grantor is treated as the owner of an entire trust, the grantor is considered to be the owner of the trust’s assets for federal income tax purposes. Under Rev. Rul. 85-13, a transaction cannot be recognized as a sale or exchange for federal tax purposes if the same person is treated as owning the purported consideration both before and after the transaction.

Rev. Rul. 2007-13, 2007-11 C.B. 684, addresses two different factual situations in which a life insurance contract is transferred between trusts. In Situation 1, a trust (TR1) acquired a life insurance contract in exchange for cash from a separate trust (TR2). TR1 and TR2 were both grantor trusts, which are treated as wholly owned by the grantor under subpart E of part 1 of subchapter J of the Code. Grantor was the insured under the life insurance policy subject to the transfer. Rev. Rul. 2007-13 holds that in Situation 1 that the grantor is treated for federal income tax purposes as the owner of the contract for applying the transfer for value limitations of § 101(a)(2). Therefore, the transfer of the life insurance contract between the two grantor trusts that are treated as owned by the same grantor is not a transfer for valuable consideration under § 101(a)(2).

In Situation 2 of Rev. Rul. 2007-13, a trust (TR1) acquired a life insurance policy in exchange for cash from a separate trust (TR2). TR1 was a grantor trust, which is treated as wholly owned by the grantor under subpart E of part I of subchapter J, but TR2 was not a grantor trust. Grantor was the insured under the life insurance policy subject to the transfer. Because the grantor is treated as the owner of all of TR1 but not TR2 for federal income tax purposes, grantor is treated as the owner of the cash (but not the life insurance contract) before the exchange and as the owner of the life insurance contract (but not the cash) after the exchange. Accordingly, the transfer of the life insurance contract was made for valuable consideration within the meaning of § 101(a)(2). Nevertheless, the transfer for value limitations of § 101(a)(2) do not apply. The transfer of the life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured within the meaning of § 101(a)(2)(B) and therefore is excepted from the transfer for value limitations of § 101(a)(2).

In the present situation, Taxpayer will be the grantor of Trust B. Trust A owns the life insurance policy on the life of Taxpayer that Taxpayer plans to acquire for Trust B. Clearly, the present situation is unlike Situation 1 in Rev. Rul. 2007-13 because the grantors of the respective trusts are not the same grantors. Therefore, based upon the facts provided and representations made, we conclude that there has been a transfer of the life insurance contract for valuable consideration within the meaning of § 101(a)(2). However, the transfer for value limitations of § 101(a)(2) do not apply because the transfer to Taxpayer is a transfer to the insured within the meaning of § 101(a)(2)(B).

According to the facts, the trustee of Trust B will be the beneficiary of the life insurance policy that will be owned by the trust on the life of Taxpayer. We assume that when Taxpayer dies the proceeds of the life insurance policy will be paid to the trustee beneficiary. Under § 101(a)(1), gross income does not include amounts received under the life insurance contract if such amounts are paid by reason of the death of the insured. Therefore, based upon the facts provided and the representations made, we conclude that the death of Taxpayer will not be considered a transfer that could result in a transfer for valuable consideration under the provisions and, accordingly, under § 101(a)(1) the proceeds from the life insurance contract payable by the reason of Taxpayer's death will not be included in the gross income of Trust B.

Ruling Request 5:

Section 2042(2) provides that the value of the decedent's gross estate includes the proceeds of all life insurance policies on the decedent's life receivable by beneficiaries other than the decedent's executor to the extent that the decedent possessed at death any incidents of ownership, exercisable either alone or in conjunction with any other person.

Section 20.2042-1(c)(2) of the Estate Tax Regulations provides that the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally, the term has reference to the right of the insured or the insured's estate to the economic benefits of the policy. It includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy.

Rev. Rul. 2011-28, 2011-48 C.B. 830, considers whether a grantor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held by a trust by substituting other assets of equivalent value will cause the value of the insurance policy to be includible in the grantor's gross estate under § 2042. In the ruling, the grantor, D, established and funded a trust with cash. Thereafter, the trust purchased a life insurance policy on D's life. The trust is an irrevocable trust for the benefit of D's descendants. The proceeds of the policy are payable to Trust upon D's death. T is the trustee of Trust and the terms of Trust prohibit D from serving as trustee of Trust. D cannot revoke, alter, amend, or terminate the trust. The governing instrument of the trust provides D with the power, exercisable at any time, to acquire any property held in the trust by substituting other property of equivalent value. The trust instrument provides that the power is exercisable by D in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power of substitution, D must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value. In addition, under local law, the trustee has a fiduciary obligation to ensure that the property that D seeks to substitute is equivalent in value to the property distributed to D. Moreover, if a trust has two or more beneficiaries, local law requires the trustee to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Finally, under local law and without restriction in the trust instrument, the trustee has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

The Revenue Ruling compares the facts in the ruling to the facts in Rev. Rul. 84-179, 1984-2 C.B. 195, Rev. Rul. 2008-22, 2008-16 C.B. 796, and Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975), *acq.* in result, 1977-2 C.B. 1. The Revenue Ruling states that the facts are similar to the situation in Rev. Rul. 2008-22, where the grantor's power of substitution was exercisable only in a nonfiduciary capacity. The Revenue Ruling concludes that D's retained power to substitute assets of equivalent value for a life insurance policy held by the trust is not, by itself, an incident of ownership under § 2042, provided the requirements under local law or the trust instrument, described in the preceding paragraph, are satisfied.

The facts in this case are similar to the facts in Rev. Rul. 2011-28. Under the terms of Trust B, Taxpayer's power to substitute assets is held in a nonfiduciary capacity. The terms of Trust B prohibit Taxpayer from serving as trustee of the trust. Taxpayer does not the power to revoke, alter, amend or terminate the trust. Under the terms of the trust, the assets that Taxpayer may transfer into the trust must be equivalent in value to the insurance policy that Taxpayer will receive. Under the terms of Trust B, Trustee has a fiduciary obligation to ensure that the assets substituted are of equivalent value. Accordingly, as in the revenue ruling, Taxpayer cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase Taxpayer's net worth. Further, under the terms of Trust B and under Statutes 1-12, Trustee has the ability to reinvest the assets and Trustee has a duty of impartiality to the trust beneficiaries. Accordingly, as in the revenue ruling, there will be no shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by Taxpayer.

Therefore, based upon the facts provided and representations made, we conclude that Taxpayer's power to reacquire the corpus of Trust B by substituting other property of an equivalent value will not result in Taxpayer possessing incidents of ownership under § 2042(2) in the policy.

Ruling Request 6:

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death, (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from the property.

Section 2036(b) provides, in part, that (1) for purposes of § 2036(a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property and (2) for purposes of § 2036(b)(1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of § 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, or terminate, either by the decedent alone or by the decedent in conjunction with any other person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death.

Rev. Rul. 95-58, 1995-2 C.B. 191, modified Rev. Rul. 77-182, 1977-1 C.B. 273. Rev. Rul. 77-182 previously concluded that a decedent's power to appoint a corporate trustee only in the event of the resignation or removal by judicial process of the original trustee did not amount to a power to remove the original trustee that would have endowed the decedent with the trustee's discretionary control over the trust income. Rev. Rul. 95-58 holds that if the decedent possesses the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of § 672(c)), the decedent has not retained the trustee's discretionary control over the trust income for purposes of §§ 2036 and 2038.

Rev. Rul. 2008-22, consideres whether corpus of a trust was includible in the grantor's gross estate under § 2036 or 2038 if the grantor retained the power, exercisable in a nonfiduciary capacity, to acquire property held in the trust by substituting other property of equivalent value. The facts in this ruling are similar to the facts in Rev. Rul. 2011-28, except that in the latter ruling, the corpus consists of a life insurance policy. The Service cited Restatement (Third) of Trusts, § 79 for the general rule, that in situations where the grantor of a trust holds a nonfiduciary power to replace trust assets with assets of equivalent value, the trustee has a duty to ensure that the value of the assets being replaced is equivalent to the value of the assets being substituted. Further, as in Rev. Rul. 2011-28, under the terms of the trust, the assets D transfers into the trust must be equivalent in value to the assets D receives in exchange and the trustee has the fiduciary obligation to ensure that the assets exchanged are of equivalent value. Accordingly, the Service stated that D cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase D's net worth. Further, in view of the trustee's ability to reinvest the assets and the trustees duty of impartiality regarding the trust beneficiaries, the Service reasoned that the trustee must prevent any shifting of benefits between or among the beneficiaries that could otherwise result from a substitution of property by D. The Service concluded, that under these circumstances, D's retained power will not cause the value of the trust corpus to be included in D's gross estate under § 2036 or 2038.

The circumstances in this case, as discussed above under Ruling Request 5, mirror the circumstances in Rev. Rul. 2008-22. Accordingly, based upon the facts provided and the representations made, we conclude that the corpus of Trust B is not includible in Taxpayer's gross estate under §§ 2033, 2036, and 2038.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure
Copy for § 6110 purposes
Copy of this letter